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Could the 1998 economic crisis recur?

Five years have elapsed since the Russian financial crisis that went down in history as the 1998 default. Perhaps it is only Ukraine and Belarus that refer to it as the Russian crisis, since the Russian Federation itself views it as a logical consequence of the financial problems in Southeast Asia which spilled over to Eastern Europe and Latin America. The issue, of course, is not in the terminology, but in the development dynamic and skills of shielding the national economy from cataclysms experienced in global markets. At that time, Ukraine turned out to be defenceless. That is why today, when the country is suffering from the consequences of a food crisis, bracing itself for another poor harvest as well as political reforms, and waiting for the liberalisation of monetary and lending policy, it is important to recall why it happened to us and to evaluate the risks of a recurring crisis in Ukraine

The Russian financial crisis of 1998 was a classical time bomb, with systemic conditions being constantly aggravated by market factors. When analysing the reasons behind those developments, it is important to isolate the systemic causes for the August default; they include the following:

• structural problems of the Russian economy, which are typical for the former USSR republics (excessive government interference in the economy, underdeveloped market institutions, a weak stock market, etc.);

• imbalanced budget policy pursued by the government;

• risky policy of public borrowing;

• policy of artificially propping up the national currency.

The effect of these internal systemic factors was aided by external factors such as volatility (poor predictability) of global financial markets as a result of the Asian financial crisis that had erupted in 1997 in Southeast Asia and hurt the global economy, combined with overly low prices on Russia's staple export item—oil. Political instability also contributed—namely, the threat of dissolving the State Duma and the miners' strikes. The decisions of the Russian government dated 17 August 1998 were the bomb's indicator rather than its detonator, warning the public about the imminent explosion.

Recall also that the currency corridor parameters were drastically revised then; this decision, immediately following the statements of President Boris Yeltsin that the rouble would not be devaluated completely undermined the trust of market agents. In addition, a number of restricting measures were implemented with regard to currency operations (in particular, a 90-day moratorium on banks' payments on loans from non-residents); and future unilateral debt restructuring was announced for State Treasury obligations—federal loan bonds (T-bonds). In fact, this amounted to an announcement that the state was unable to pay its debts, and the word default, little known in this part of the world, came into use.

The reaction of individuals and businesses was predictable—Russians were stricken with panic buying of American dollars and withdrew their bank deposits, the shares of Russian companies depreciated, and many sales outlets closed for inventory. The Central Bank had to cancel dollar trading at the Moscow Interbank Currency Exchange (MICEX), stating that currency reserves could not be spent to buoy the rouble.

Financial conflagration in Ukraine

It is utterly incorrect to maintain that a large trade turnover and the traditional economic connections between the two republics of the former USSR were behind the 1998 crisis in Ukraine.

In fact, in reforming its economy during the 1990s, Ukraine had simply followed Russia's pattern, with a one- or two-year delay. As a results, all the remarks about the systemic reasons, typical for the Russian Federation at that time, are applicable to Ukraine as well.

The exacerbated global crisis, which in 1998 spilled over from Asia to Eastern Europe and Latin America, triggered the flight of capital from Ukraine.

While in H1'98 the balance of payments could somehow or other be bolstered by placing domestic and foreign government bonds, in H2'98 these sources of financing were no longer possible.

Ukraine was then saved from bankruptcy by loans from international organisations, precise actions of the National Bank of Ukraine in the money market, and a relatively successful conversion of state securities.

As Russia did, Ukraine was forced to renounce its currency corridor. A new range of hryvnia-to-dollar fluctuations was announced—2.5–3.5 UAH/USD. This led to a final loss of investors' trust, since they had come to the Ukrainian market expecting that by year-end 1998 the hryvnia rate would not sink below the 2.25 UAH/USD declared by the government. On the other hand, if the NBU had not abandoned its former parameters of the currency corridor and resorted to a drastic hryvnia depreciation, it would have lost all its currency reserves, which anyway had shrunk to 700 million USD by the end of September.

The fundamental reasons for Ukraine's 1998 economic crisis were the lack of vital reforms at the enterprise level, as well continuing unnecessary and ineffective state expenditures, which unbalanced the budget. Direct budget financing and, later, hidden subsidies in the form of tax benefits and special loans, as well as the silent consent of the government to budget non-payments and payment of taxes by way of mutual debt write-officials, perceptibly undermined the performance of former Soviet enterprises. A low privatisation rate, along with poorly motivated lax private business activity at the state level, failed to overcome the ruinous economic policy pursued by the government.

The unreformed economy continued to unbalance the budget. Having refused the National Bank's direct loans, which produced only a short-lived inflationary effect, in 1996 the government first entered the market of domestic public borrowing, then in 1997 went to foreign capital markets. At that time, it seemed a cure-all; the 1997 budget deficit surged to

6.7% of GDP, while the redistribution of the gross national product via budget approached the value of the early 1990s—33%. The sequestration of the budget declared in summer could not save the day.

A small victory for the Finance Ministry—Ukraine's first entry to international loan markets, which allowed to attract about 1 billion USD and replenish currency reserves—nearly turned into a Pyrrhic one. It was only thanks to tremendous effort that Ukraine in 2000 was able to restructure its euro-obligations and avoid declaring a default, which would cut off access to external financing for a long time.

Thus, in 1998 the Ukrainian government ended up paying for its irresponsible economic policy in the mid-1990s. Instead of anticipated economic growth and strengthened financial stability, the country again witnessed a drop in GDP, an abruptly depreciated national currency by 80% per annum, a 20% growth of the annual inflation indicator, and a considerable decline in real personal incomes.

Lessons from the crisis

The 1998 financial crisis taught Ukraine the two probably most vital lessons of its new history. Firstly, the budget gap should not be big for a long time under a negative balance of payments; sooner or later, the explicit or implicit deficit will trigger a macroeconomic imbalance. The real positive result of 1998 was the arrested growth of the debt pyramid, which sooner or later would have crumbled because of irrational use of funds by the government; also, secondly, it ultimately became obvious that the government was not to be trusted.

Those who failed to understand this idea in 1991–1992 came to grips with it in 1998. Probably, that shock became the most powerful impetus to unleash the economic activity of the population than all reforms undertaken before that, and heralded a high rate of economic growth in 2000–2003.

The currency depreciation, however late, bolstered the economy immensely. In many sectors, enterprises that were on the verge of capitulating before foreign rivals were bestowed with the "gift" of a sudden surge in prices for foreign products. Many enterprises took advantage of the time gained to re-charge their batteries and strengthen their standing in the domestic market.

In many ways, the August crisis of 1998 acted as a "shock therapy" for Ukraine, the idea of which had been suggested in the early 1990s by Western advisors, while Russian liberal reformists followed by their Ukrainian counterparts adopted it as half measures. The therapy of 1998 helped tremendously in eradicating the domination of the "virtual economy" in Russia (this term was introduced by the prominent American economists Geddy and Ickes). One of the consequences of the crisis was the sudden tightening of budget policy. Since then, the government's "norm of decorum" became the adoption of a deficit-free or small-deficit budget.

The crisis also taught the IMF a great lesson, whose policy was heavily castigated for its ineffectiveness in transition economies. Consequently, in the late 1990s international financial organisations revised their working principles. It was officially acknowledged that their financial assistance could not be regarded as a cure-all—it only allows to cover up financial problems in an ailing national economy and refrain from undertaking crucial reforms.

Default II—is it possible?

Over the past five years, Ukraine has encountered crisis situations more than once; it is sufficient to recall the gasoline crisis in the summer 1999 and, again, this year's food crisis.

The developments of summer 2003 vividly signalled about the lack of an effective government policy in the grain market. On the one hand, market mechanisms have not been formed so far, the market remains non-transparent, and therefore cannot react adequately to demand/supply changes. On the other hand, the state renounced its stabilising role and started to pay less attention to the formation of national reserves of strategic goods (foodstuffs, oil, gasoline). This may trigger sharp price fluctuations in the market, and hence, cause a systemic crisis. Having on hand only its levers of administrative pressure upon enterprises, without trustworthy information about the grain (oil, etc.) balance, the state has turned out to be unprepared for the crisis in the market for bare necessities.

There is still a risk of distortions in tax and pension reform. The forecast for an increase in the tax base as a result of decreased tax rates is grounded upon expectations of a considerable "de-shadowing" of entrepreneurs and profit legalisation. However, the reform also envisages to abruptly slash tax benefits. There is a high risk of many of the entrepreneurs who had enjoyed the benefits going into the shadow. Consequently, a mitigated tax pressure and reduced benefits may trigger not only a drop in budget revenues, but also "unexpected" narrowing of the tax base.

The next risk factor to be admitted is a high dependence on the external market situation. Recently, Ukrainian producers have managed to expand external markets. Conditions beneficial for export growth include price increases for Ukraine's staple exports and real depreciation of the Ukrainian currency (according ICPS calculations, the Ukrainian currency under the real effective exchange rate is worth half of its cost today compared to the early 1998). Regardless their non-participation in the WTO, Ukrainian goods are in steady demand abroad.

Nevertheless, the economy's dependence upon external demand is looming large. Exports have already gone above 60% of GDP. Along with that, ferrous metals account for almost one-third of exports. In the meantime, metallurgical producers announce a decline in profitability. This means that dramatic fluctuations in the market for ferrous metals, for example, an intensified competition from Asian producers, in the first place, or a deteriorated economic situation of major trading partners of Ukraine are able to seriously sap the profits of exporters. In this situation, it is crucial to focus on domestic market development, and to foster domestic consumption. It is essential to strengthen Ukraine's standing as a principal transit state in the region.

One of the paramount implications of the crisis was the loss of investors' trust, which is far more difficult to win back than to restore a favourable market situation. Judging from recent developments in both the Russian Federation and Ukraine having to do with pursuing "political and economic ends", August of 1998 never taught the government to treasure this trust.

In the meantime, the banking system has got into habit of replenishing their resources from a rapid growth in deposits. At the same time, a high risk of escalating inflation may entail a faster growth of prices than of deposit rates. The risk of disrupted inflow of deposit money to banks will alter today's way of banking business, which may drive up the number of loss-making banks.

Thus, the above-mentioned "weaknesses" of the Ukrainian economy are unlikely, as they are, to set off the crisis, which, by its scale, may be compared to that of 1998. But solely successful government actions of preventing any possible distortions in specific segments of the economy, proceeding with comprehensive market reforms, setting well-defined economic goals can diminish chances of crunch situations.■

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